IT 98-10
Tax Type: INCOME TAX
Issue: Insurance Company Issues

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	
	)	No. 92-IT-0000
v.	)	95-IT-0000
"GRABOWSKI'S" INSURANCE ASSOCIATION,	)	TYE: 12/31/00 to 12/31/00
Taxpayer	)	C. O'Donoghue Admin. Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. Lawrence Friedman of Lord, Bissell, & Brook for "Grabowski's" Insurance Association; Mr. Thomas P. Jacobsen, Special Assistant Attorney General for the Illinois Department of Revenue.

Synopsis:

This matter comes on for hearing pursuant to "Grabowski's" Insurance Association and "Pulaski" Insurance Company's (unitary "taxpayer" or "Grabowski") timely protest of two Notices of Deficiency. The first Notice was issued by the Department of Revenue ("Department") on July 2, 1992 for the years ending 12/31/00, 12/31/00, and 12/31/00. The second Notice for the year ending 12/31/00 was issued on November 18, 1994. The Department has proposed adjustments

based on its contention that the taxpayer improperly calculated its Illinois base income by failing to "add back" all interest income "excluded from gross income," as required by 35 ILCS 5/203(b)(2)(A). The issues, as stipulated by the parties, are as follows:

Was the Department correct in adjusting the Illinois Income Tax Act Section 203(b)(2)(A) addition modification for tax exempt interest of the taxpayer's unitary business group, which are property and casualty insurance companies and subject to Internal Revenue Code Sections 831 to 835, for the tax years ending 12/31/88, 12/31/89, 12/31/90 and 12/31/92, described in the notices of deficiency dated July 2, 1992 and November 18, 1994, from 85% to 100% - the 15 percentage point difference between the addition modification reported by the taxpayer and the addition modification as adjusted by the Department represents the reduction of "losses incurred" pursuant to Internal Revenue Code Section 832 (b)(5) - of the interest received by the taxpayer.

Whether the Department was correct in imposing the Section 1005 penalties for the tax years ending 12/31/88 to 12/31/90 and 12/31/92.

Upon consideration of the record, it is recommended that the IITA Section 203(b)(2)(A) addition modification issue be resolved in favor of the Department and that the penalties assessed under Section 1005 be cancelled.

Findings of Fact:

1. The Department's prima facie case, inclusive of all jurisdictional elements, was established by the admission into evidence of the Notices of Deficiency ("NOD"), issued on July 2, 1992 for the tax years ending 12/31/00, 12/31/00 and 12/31/00 and on November 18, 1994 for the tax year ending 12/31/00. Stipulation of Facts 3; Stip. Exhibits 5 & 6. The Department's notice

for the 1992 tax year, advised the taxpayer through a schedule that the Department's audit had determined that the taxpayer had an overpayment for the tax year ending 12/31/00. Stip. 3.

2. "Grabowski's" Insurance Association and "Pulaski" Insurance Company were engaged in the business of insuring property and casualty risks and comprised a unitary business group, as reported on the combined unitary returns filed for the tax years ending 12/31/00, 12/31/00, 12/31/00, 12/31/00 and 12/31/00 ("Audited Tax Years"), including original and amended returns. Stip. 1 & 2; Stip. Exhibits 1-4 & 11.

3. Subsequent to the issuance of the notices of deficiency, the taxpayer filed a timely Form IL-1120-X for the tax year ending 12/31/00 dated April 14, 1994, reporting a federal change. Stip. 5; Stip. Exhibit 11. The Department reviewed the Form IL-1120-X and incorporated the federa change into the audit results, revising the proposed assessment. Stip. 5; Stip. Exhibit 12.

4. The adjustments to the addition modification for tax-exempt interest that are the subject of the administrative hearing are as follows, as reflected in Stip. Exhibits 5, 6, 7, 8 and 12:

TYE	ADDITION MODIFICATION AS REPORTED	ADDITION MODIFICATION AS ALLOWED	ADJUSTMENT CONTESTED
12/31/00	2,455,030	2,621,942	166,912
12/31/00	2,368,133	2,570,229	202,096
12/31/00	2,067,454	2,253,451	185,997
12/31/00	2,551,178	2,905,604	354,426

Stip. 7.

5. The addition modifications reported by the taxpayer on the Forms IL-1120 (line 2a) and the adjustments by the Department to the addition modifications were based on the tax-exempt interest shown on the timely filed US Forms 1120-PC of "Grabowski's" Insurance Association and "Pulaski" Insurance Company for the audited Tax Years. Specifically, the reported addition

modifications and the adjustments relate to the 15% reduction of losses incurred as described in Internal Revenue Code Section 832(b)(5) and computed on Schedule F of the US Forms 1120-PC. Stip. 8; Stip. Exhibits 13-20.

Conclusions of Law:

"Grabowski's" is a corporation subject to pay tax in Illinois on its "net income for the taxable year" pursuant to 35 ILCS 5/201. Net income is defined in 35 ILCS 5/202 which provides in pertinent part that "a taxpayer's net income shall be that portion of his base income for such year ... which is allocable to this State." Under the Illinois Income Tax Act ("IITA"), a corporation's base income is an amount equal to the taxpayer's taxable income for the taxable year as modified by paragraph (2). Section 203(b)(2)(A) of the IITA provides that base income shall be adjusted by:

> (A) An amount equal to all amounts paid or accrued to the taxpayer as interest and all distributions received from regulated investment companies during the taxable year to the extent excluded from gross income in the computation of taxable income;

Section 203(e) indicates that taxable income or gross income means the amount of gross income or taxable income reportable for federal income tax purposes under the Internal Revenue Code ("IRC"). Therefore, on the IL-1120 taxpayer must begin with federal taxable income on line 1 in its calculation of base income. Taxpayer is then required pursuant to Section 203(b)(2)(A) to add back all interest which has been excluded from federal gross income. IITA Section 203(e)(2)(B) substitutes insurance company taxable income as the starting point for the computation of Illinois base income. The tax exempt interest addition modification for property and casualty insurance companies, therefore, is limited to the amount of tax exempt interest that was excluded in the computation of insurance company taxable income.

As a property and casualty insurance company, “Grabowski’s” is taxed under 831 through 835 of the IRC. IRC 832(b)(1) provides that gross income of a property and casualty insurance company consists of the gross amount earned during the taxable year, from investment income and underwriting income. IRC 832(b)(2) provides that investment income is comprised of income from interest, dividends, and rents, while IRC 832(b)(3) provides that underwriting income is equal to gross premiums less losses incurred and expenses incurred.

The issue at hearing centers around the deductions described in IRC Section 832(c)(4) and (7), the losses incurred deduction and the tax exempt interest deduction. The Department contends that Section 203(b)(2)(A) requires property and casualty insurance companies to add back 100% of its tax exempt interest in computing its base income. The taxpayer, on the other hand, argues that 15% of its tax-exempt interest has been included in its federal taxable income, therefore, Section 203(b)(2)(A) only requires an addition modification of 85% of its' tax exempt interest.

This issue arises for tax years ending after December 31, 1986 due to the pro-ration concepts added to the insurance provisions of the IRC by the Tax Reform Act of 1986. IRC Section 832(b)(5)(B) provides a 15% reduction to the losses incurred deduction equal to the sum of tax-exempt interest plus other amounts not relevant to this hearing. The losses incurred deduction reflects losses paid during the year and the increase in reserves for losses incurred but not paid. Congress determined that it was inappropriate to fund loss reserves on a fully deductible basis with tax-exempt income and reduced the losses incurred deduction by a prorated portion of the tax-exempt interest which had been used to fund the taxpayer's loss reserves.

The taxpayer argues that to determine what interest has been excluded from federal gross income, we must look to the Code to define "gross income," as required by 35 ILCS 5/203(e) and, furthermore, maintains that the Code defines gross income to include 15% of tax-exempt interest as

a reduction of "losses incurred". Taxpayer's contention, however, is undermined by an examination of the IRC. Insurance company taxable income is comprised of both investment income and underwriting income. In computing insurance company taxable income, the IRC distinguishes between the tax-exempt interest deduction and the losses incurred deduction. Losses incurred is provided for in 832(b)(5) and requires that the amount "shall be reduced by an amount equal to 15% of the sum of" tax-exempt interest and the deductible portion of dividends received. IRC 832(b)(3) clearly identifies the losses incurred deduction as an adjustment to underwritin income, thus, the 15% losses incurred deduction reduction is expressly limited to the computation of underwriting income. The tax-exempt interest and the dividend deduction, therefore, are used only as a means to measure the allowable losses incurred deduction.

The IITA requires that taxpayers add back all interest excluded from gross income in the computation of taxable income and 100% of tax exempt interest is, in fact, excluded from gross income in the insurance company taxable income computation and the 15% arithmetic effect to federal taxable income occurs only due to a reduction to the losses incurred deduction. An examination of the US 1120-PC, Schedule A, supports this interpretation as it expressly excludes tax-exempt interest in the computation of gross income (Line 14). Tax exempt interest (Line 3b) is subtracted from gross interest (Line 3a) to obtain taxable interest (Line 3c) which is the amount that is added to gross income. The use of "excluded" in the addition modification provision refers only to the exclusion of tax exempt interest from gross income that is allowed under IRC Section 103 for all taxpayers. The language of IRC 832(c)(7) clearly describes the tax-exempt interest deduction as the amount of interest that is excluded from gross income pursuant to IRC 103. Moreover, the legislative history describes the tax-exempt interest deduction as making the IRC 103 exclusion available for eligible investment or interest income of the property and casualty insurance

companies. (See, General Explanation of the Tax Reform Act of 1986, Joint Committee on Taxation, p. 598, Dept. Attachment 2). The addition modification provision does not encompass the 15% losses incurred deduction reduction because this reduction is used for a different purpose than that which the term "excluded" means in Section 203(b)(2)(A).

The taxpayer cites two Wisconsin cases in support of its position, Wisconsin Department of Revenue v. Heritage Mutual Insurance Company, 208 Wis. 2d 582 (1997) and American Family Mutual Insurance Company v. Wisconsin Department of Revenue, Wisconsin Tax Appeals Commission, 94-I-1009 (April 11, 1996), CCH Wisconsin Tax Reports - New Matters, 400-212. Both decisions were based upon the Courts' interpretation of Section 71.45(2) of the Wisconsin Franchise and Income Tax Act. Paragraph (3) in effect prior to 1989, provided that the federal taxable income, that was the basis for the Wisconsin income tax, was adjusted, "by adding to federal taxable income an amount equal to interest income received or accrued during the taxable year to the extent such interest was used as a deduction in determining the company's federal taxable income." The subsequent rewording of the statute which was the basis of the American Family decision provided for an adjustment "by adding to federal taxable income an amount equal to interest income which is not included in federal taxable income." In Heritage Mutual, supra, the Wisconsin Court of Appeals determined that Wisconsin law required that 85% of tax exempt interest be added back to federal taxable income because 15% of tax exempt interest was applied to reduce a loss deduction in arriving at the taxpayer's federal taxable income. The Court found that the Wisconsin statute allowed the insurer to add back the amount of interest income received to the extent such interest was used as a deduction in determining the taxpayer's federal taxable income, and, accordingly, the taxpayer had properly calculated its addition modification. Id.

The language of the Wisconsin and Illinois statutes is significantly different and as a result the persuasiveness of the courts' analysis is limited. The Wisconsin statute refers to a deduction or non-inclusion while the reference in IITA Section 203(b)(2)(A) is to the amount excluded, which limits the analysis to the effect of IRC Section 832(c)(7) - the deduction that in effect provides for the exclusion of tax exempt interest pursuant to IRC Section 103.

Taxpayer also contends that the Department's interpretation of the statute violates the Equal Protection Clause of the fourteenth amendment to the U.S. Constitution. Taxpayer looks towards Continental Illinois National Bank and Trust Company of Chicago v. Lenckos, 102 Ill. 2d 210 (1984), where the Illinois Supreme Court held that interpreting IITA Section 203(b)(2)(A) to accord different treatment to federally taxable bonds than to federally tax-exempt bonds was unconstitutional and contends that it applies with equal force in the case at hand.

The Illinois Supreme Court in Continental considered whether the taxpayer added back the proper amount of federal tax-exempt interest income in calculating its Illinois base income. Continental like Farmers, had interest income from state and local bonds which was exempt from federal tax and had to be added back to calculate its Illinois base income. When purchased, Continental paid a premium and, thereafter, reduced its municipal interest addition modification for amortization of the bond premium. The Court determined the meaning of the term "interest" under Section 203(b)(2)(A) and allowed the amortized premium adjustment. Under federal law, the premium was a return of capital, thus, disallowing a reduction for the amortized premium would improperly result in the taxation of capital, rather than net income. Id., at 218.

In addition, the Supreme Court in Continental concluded that interpreting the statute to allow taxation of the premium for tax-exempt bonds would result in the disparate treatment of federally tax-exempt bonds and federally taxable bonds. Id. The Court determined that this

interpretation of the Act would be unconstitutional. The Continental decision was premised upon the fact that under federal law amortization of bond premium is a return of capital. Federally taxable bonds were allowed a deduction under federal law for amortized bond premium, thus, this amount was not included in the bond holder's federal taxable income which flowed to line 1 on the Illinois income tax return. A deduction was not allowed for tax-exempt bonds, therefore, this premium was included in the tax-exempt bond holder's federal taxable income. To not allow the bank to reduce the interest received by the amortized bond premium would have resulted in taxing federally tax-exempt bonds at a higher rate than federally taxable bonds for state tax purposes.

Here, the Department's interpretation of the statute does not violate the equal protection clause in that it accords the same treatment to insurance companies that it does to all other taxpayers; it requires the taxpayer add back 100% of its tax-exempt interest. To allow the taxpayer to add back only 85% of its tax-exempt interest would result in favorable treatment. Taxpayer cannot point to a section which clearly indicates that 15% of tax-exempt interest is included in insurance company taxable income, thus, it is not truly being taxed on 115% of its tax-exempt interest as claimed, only 100% as are all other taxpayers with tax-exempt interest income.

The remaining issue is whether the Department's proposed assessment of penalties under 100 of the IITA should stand. 35 ILCS 5/1005 (formerly Ill. Rev. Stat. 1991, ch. 120, 10-1005). Section 1005 provides that the penalty shall not apply if the taxpayer's failure to pay is due to reasonable cause. The Department's regulations state that reasonable cause is to be determined on a case by case basis taking into account all of the facts and circumstances. 86 Admin. Code ch. I, Sec. 700.400(b). Section 700.400 indicates that it must be determined to what extent the taxpayer made a good faith effort to determine the correct tax liability and subsection (c) provides that a taxpayer is considered to have made a good faith effort if he uses ordinary business care and

prudence. Factors which are considered in determining whether the taxpayer exercised ordinary business care and prudence are the clarity of the law and its interpretation, and the taxpayer's education, experience and knowledge. Id.

The Tax Reform Act of 1986 changed the calculation of taxpayer's federal taxable income and as a consequence its Illinois taxable income. The change in the federal law arguably made the interpretation of Section 203(b)(2)(A) unclear and the Department did not have a regulation on point. The taxpayer reasonably interpreted the statute by eliminating the arithmetic effect of the amendment to IRC 832(b) from the calculation of its Illinois taxable income. There was then no published authority in support of either the Department's position or that of the taxpayer. Accordingly, the taxpayer's interpretation of Section 203(b) of the Act was made in good faith and it is my recommendation that the Section 1005 penalties should be abated.

Wherefore, for the reasons stated herein, the Notices of Deficiency should be finalized as revised by this recommendation.

Enter:

Christine O'Donoghue
Admin. Law Judge

. As of 1/1/94, the penalty for underpayment of tax is provided for in Section 3-8 of the Unifor Penalty and Interest Act.